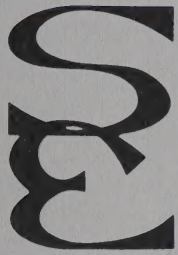


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**SOUTHWARD
ENERGY LTD.**

**ANNUAL REPORT 1987
AUGUST 31st**

PRESIDENT'S MESSAGE

To the Shareholders:

In reviewing the past year, I must first thank the staff and board of directors of Southward Energy Ltd. for their efforts and dedication in operating your company in a business climate that has not been conducive to profitability and growth. During this past year the volatility of oil prices and a continuation of soft natural gas prices and shrinking markets impacted on our ability to finance the company's exploration budget.

FINANCIAL

During the year your Board of Directors made the decision to change its method of accounting from Successful Efforts to Full Cost. This was done to give a more accurate picture of Southward's current net asset value as it appears on the balance sheet. This change will be of positive future benefit to the company as 1988 is projected to be a very active year for capital expenditures. To this end the Full Cost method of accounting will smooth the negative effect of any unsuccessful drilling on the profit and loss statement over a number of years.

GENERAL

As stated in previous reports to the shareholders, your management had three main objectives to accomplish in 1987.

Firstly, we established through exhaustive research that a breakthrough in natural gas sales for the industry would occur in the near future. Also because the large majority of Southward's revenue is generated by oil sales, your board of directors issued a mandate to the staff to formulate a "gas search program." This would accomplish two important results. With future markets available for gas sales and a more balanced proportion of revenue from marketing both oil and gas, the company would be in a much better position to effect growth and reduce the risks of exterior forces, such as O.P.E.C., impacting the stability of our cash flow.

Additionally, we determined that a concentrated effort to secure firm long term gas markets prior to expending funds on gas exploration would be more prudent by assuring immediate marketability of new found gas reserves. To this end your staff procured three gas markets for a potential of twelve million cubic feet of gas sales per day.

Secondly, we required proper financing to establish an exploration budget for the "gas search program." This presented more of a problem than expected with three disappointing events that delayed the securing of financing until recently. These three disappointments came about over a period of nine months and culminated in the disastrous events of the stock market plunge in October 1987. The final method of financing took the form of a joint venture with a private oil and gas company. Although we view this as a temporary method of funding our exploration budget, it is ideal in that there is no dilution of equity or debt associated with it.

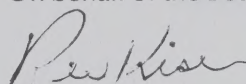
The third objective is the search for new oil and gas reserves. Southward acquired the technical support of Mr. Lorne Hill, an experienced and successful geologist, who now heads up our exploration department. Through Mr. Hill's efforts, the company has designed several gas "plays." The successful drilling of these prospects will allow us to generate immediate cash flow. Although only one exploration well was drilled last year, we anticipate that ten or more wells will be drilled during 1988.

Southward's Board of Directors is projecting a banner year for the company. Recent stock prices for your company's shares should not be used as a barometer for future prices based on a successful exploration program.

Many junior resource companies are attempting to create growth by purchasing oil and gas reserves. The newly formed junior capital pool companies or "nickel" deals have taken this route in order to accomplish their "major transaction." Southward is committed to growth and profitability through basic exploration efforts. Any successful oil and gas company requires hard work and skill from their staff to foster growth. With any degree of "good luck" in exploration, growth can be dynamic.

Your board of directors and staff anticipate dynamic growth for your company in 1988!

On behalf of the Board of Directors:



R.W. Kiser,
President

OPERATIONS

As Vice President of Operations of your company I am pleased to submit the following report covering Southward's 1987 operations and our 1988 future projects.

1987 Operations

As a result of a limited 1987 capital budget the company's activity was restricted to the acquisition of a 25% working interest in approximately 2500 acres of Alberta crown lands and the drilling of one unsuccessful well and completion of a Glauconite gas well. As a result of these operations additional cash flow from the completed well is expected to range from 3 to 4 thousand dollars per month when tied in and placed on stream. The company is currently reviewing a farmout proposal on one section of the purchased lands.

Future Projects

The company's 1988 budget incorporates prospects which are 80% low to moderate risk and 20% exploratory.

Southward recently posted certain Alberta Crown lands for the August 1988 sale. If these lands are successfully acquired as many as two wells will be drilled for Devonian gas potential this fall and winter.

The company also committed to farmin on certain Alberta lands in the Big Valley area. A well should be spudded before the end of June 1988 on these lands. Southward will retain a 5% working interest after payout in the test well and option lands. The project is a seismically controlled extension to proven reserves in excess of 200 thousand barrels of oil per quarter section.

Your company is currently reviewing a farmin opportunity on additional Alberta lands to provide for further drilling activity of up to six wells through the last calendar quarter of 1988 and the first quarter of 1989. These lands offer gas potential to further satisfy the company's gas contracts.

Southward has several other projects at various stages of development. These mostly gas related prospects will be brought to a commitment stage (farmin or crown purchase) as our exploration staff completes each study. Southward's interests in these opportunities will range from 10% to 50%.

Southward recently participated in the drilling of two successful Alberta wells for which the results are identified in the 1988 second quarter report. The company will also be joining in the drilling of a development well in Saskatchewan which should be spudded in early May of 1988.

Saskoil et al Willmar, Saskatchewan:

Southward will hold a 9% working interest in the drilling of a potential oil well to be spudded after breakup. This development well is an extension to the 9 successful oil wells participated in by the company from 1984 through 1986 in which Southward holds an average interest of 14%. The proposed location is directly adjacent to one of Southward's best wells which has produced at rates approximating 160 barrels of oil per day.

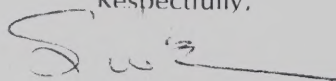
Southward's exploratory budget for 1988 and 1989 currently includes acquiring land and seismically defining and drilling D2 reefs in central Alberta.

Southward recently agreed to participate to the extent of a 20% working interest with four other companies to jointly explore for these reefs. The high cost of shooting seismic in the area will be mitigated by using a unique technique to locate bypassed anomalous structures which remain undrilled. Anomalies defined using this approach will be high-graded using conventional seismic data.

To date a dozen or more undrilled features appear to exist. The five best anomalies have been chosen for further analysis. Successful acquisition of the mineral rights would lead to a winter seismic program to confirm the structures. Seismic costs covering these lands range from 25 - 50 thousand dollars per anomaly. Wells would be drilled at a cost of about \$550,000 cased. Successful wells could yield some 1 - 5 million barrels of crude oil with production rates ranging from 500 to 5000 barrels of oil per day.

Southward's mandate is to explore for and develop natural gas and crude oil sufficient to meet Southward's increasing contract requirements. Accomplishment of this mandate will provide cash flow sufficient to sustain an active exploration program coincident with building the company's asset value to justify substantial increases in common stock trading prices.

Respectfully,



S.W. Kiser,
Vice President, Operations

**SOUTHWARD ENERGY LTD.
CONSOLIDATED FINANCIAL STATEMENTS
AUGUST 31, 1987**

AUDITOR'S REPORT

The Shareholders
Southward Energy Ltd.

We have examined the consolidated balance sheet of Southward Energy Ltd. as at August 31, 1987 and the consolidated statements of operations and deficit and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at August 31, 1987 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied, after giving retroactive effect to the change in the method of accounting for gas and oil properties as explained in Note 2 to the consolidated financial statements, on a basis consistent with that of the preceding year.

Calgary, Alberta
January 25, 1988

St. Louis Geib
Chartered Accountants

**SOUTHWARD ENERGY LTD.
CONSOLIDATED BALANCE SHEET
AUGUST 31, 1987**

ASSETS

	1987	1986
Current		
Cash	\$ 678	\$ 314
Accounts receivable	90,312	49,711
	<u>90,990</u>	<u>50,025</u>
Fixed (Note 3)	1,136,149	1,044,790
	<u>\$1,227,139</u>	<u>\$1,094,815</u>

LIABILITIES

Current		
Bank indebtedness (Note 4)	\$ 110,574	\$ 250,000
Accounts payable and accrued	143,065	148,665
	<u>253,639</u>	<u>398,665</u>
Convertible debentures (Note 5)	265,000	—
Contingency (Note 6)		

SHAREHOLDERS' EQUITY

Share capital (Note 7)	1,488,029	1,388,029
Deficit	(811,609)	(723,569)
Cumulative translation gain	32,080	31,690
	<u>708,500</u>	<u>696,150</u>
	<u>\$1,227,139</u>	<u>\$1,094,815</u>

On behalf of the Board:
R.W. Kiser, Director
S.W. Kiser, Director

**SOUTHWARD ENERGY LTD.
CONSOLIDATED STATEMENT OF OPERATIONS AND DEFICIT
FOR THE YEAR ENDED AUGUST 31, 1987**

	1987	1986
Revenue		
Operators fees	\$ 22,211	\$ 3,812
Production	306,111	462,883
Interest earned	125	4,298
	<u>328,447</u>	<u>470,993</u>
Direct expenses		
Operating	56,387	102,578
Depletion and depreciation	106,579	133,004
	<u>162,966</u>	<u>235,582</u>
Revenue from operations	165,481	235,411
Other expenses		
General and administrative	206,347	194,394
Interest and bank charges	19,740	21,520
Debenture interest	17,748	—
	<u>243,835</u>	<u>215,914</u>
Operating loss (income) before undernoted item	78,354	(19,497)
Write down in carrying value of petroleum and natural gas properties (Note 3)	<u>9,686</u>	<u>133,012</u>
Loss for the year	88,040	113,515
Deficit, beginning of year	723,569	610,054
Deficit, end of year	<u>\$811,609</u>	<u>\$723,569</u>
Net loss per share	<u>\$.04</u>	<u>\$.05</u>

**SOUTHWARD ENERGY LTD.
CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEAR ENDED AUGUST 31, 1987**

	1987	1986
Operating activities		
Loss for the year	\$ (88,040)	\$ (113,515)
Charges (credits) to income not requiring cash		
Effect of exchange rate changes on working capital	390	6,416
Depreciation and depletion	106,579	133,004
Write down in carrying value of petroleum and natural gas properties	9,686	133,012
	<u>28,615</u>	<u>158,917</u>
Net change in non-cash working capital balances related to operations	<u>(46,201)</u>	<u>(211,702)</u>
	(17,586)	(52,785)
Financing activities		
Proceeds of share subscription	100,000	—
Proceeds of flow through shares	—	25,000
Allocation of drilling costs to share capital	—	(31,080)
Issuance of debentures	265,000	—
	<u>365,000</u>	<u>(6,080)</u>
Investing activities		
Acquisition of fixed assets	(212,670)	(369,064)
Allocation of drilling costs to flow through share subscribers	—	31,080
Government grants	4,777	49,214
Proceeds on sale of petroleum and natural gas properties	269	55,089
Proceeds on sale of auto	—	3,600
	<u>(207,624)</u>	<u>(230,081)</u>
Changes in cash during the year	139,790	(288,946)
Cash at beginning of year	<u>(249,686)</u>	<u>39,260</u>
Cash at end of year *	<u><u>\$(109,896)</u></u>	<u><u>\$(249,686)</u></u>

* Cash at end of year consists of short-term bank borrowings less cash.

**SOUTHWARD ENERGY LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED AUGUST 31, 1987**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Southward Energy Ltd. is a publicly traded company engaged in the oil and gas business and is incorporated under the Alberta Business Corporations Act. These financial statements are prepared in accordance with generally accepted accounting principals, the more significant of which are:

a) Consolidation

The consolidated financial statements include the accounts of the company and its wholly-owned subsidiary, Southward Resources Inc.

b) Oil and gas operations

The company follows the full cost method of accounting in accordance with the guideline issued by the Canadian Institute of Chartered Accountants whereby all costs associated with the exploration for, and development of, oil and gas reserves, whether productive or unproductive, are capitalized in cost centres. Such costs include land acquisition, drilling, geological and geophysical expenses related to exploration and development activities.

Gains or losses are not recognized upon the disposition of oil and gas properties unless such a disposition would change the depletion rate by 20% or more. Gains and losses are recognized upon the disposition of other assets.

Carrying values of oil and gas properties and share capital are reduced by grants received and transferred to flow through shareholders. Other grants earned under various government incentive programs are accrued and applied against the related expenditures.

c) Depreciation and depletion

Furniture and fixtures are depreciated on a 20% declining balance basis. Tangible equipment, oil and gas properties and intangibles are depleted on the unit of production method, based on proven reserves of oil and gas as determined by independent engineers and management's estimates. Natural gas reserves are converted to equivalent barrels of oil based upon the relative energy content of each product. In calculating depletion, gross proven reserves (before royalties) are used. Cost centres for purposes of calculating depletion are segregated between Canada and the United States.

d) Ceiling limitations

The net carrying value of the company's oil and gas properties is limited to an ultimate recoverable amount which is the aggregate of future net revenues from proved reserves and the costs of unproved properties net of impairment allowances, less future operating costs. Future net revenues are estimated using year-end prices discounted at 15%.

e) Income taxes

The company accounts for income taxes by the tax allocation method, whereby income tax expense is determined as the amount that would be payable if statutory tax deductions for drilling, exploration and property acquisition costs and for capital cost allowances were claimed for tax purposes at the same rate as the related depletion and depreciation provisions charged against income.

f) Foreign currency translation

The company translates the accounts of the U.S. subsidiary to Canadian dollars by translating the balance sheet at the rate in effect at the year-end date. The statement of operations is translated at the average rate for the year. The effect of the translation is included in shareholders' equity.

2. CHANGE IN ACCOUNTING POLICY

During fiscal 1987, Southward changed its method of accounting for gas and oil exploration and development activities from the successful efforts method to the full cost method.

Previously, a provision for the impairment of the capitalized carrying value of petroleum and natural gas leases and associated drilling and equipment expenditures was made based on the estimated net realizable value of reserves, on a project by project bases. Impairment is now measured on a cost center basis. As well, dry hole, lease rental, geological and geophysical costs previously charged to expense in the year incurred are now capitalized.

SOUTHWARD ENERGY LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)
FOR THE YEAR ENDED AUGUST 31, 1987

2. Change in Accounting Policy (Cont.)

These changes have been applied retroactively, as outlined in Note 1 (b) and have increased amounts reported in 1986, for net petroleum and natural gas properties by \$105,039 and reduced the deficit by \$35,983. The loss reported for fiscal 1986 was reduced by \$60,461 while cumulative losses prior to 1986 increased by \$24,878. The reported loss for fiscal 1987 was decreased by \$608,153 as a result of converting to full cost.

3. FIXED, at Cost

	1987	1986
Petroleum and natural gas properties	\$1,474,099	\$1,294,754
Furniture and equipment	32,663	14,070
	<u>1,506,762</u>	<u>1,308,824</u>
Less accumulated depletion and depreciation	370,613	264,034
	<u>\$1,136,149</u>	<u>\$1,044,790</u>

The carrying value of the petroleum and natural gas properties was reduced by \$9,686 (1986 - \$133,012) to reflect the adjusted value of the underlying oil and gas reserves. The write down was calculated using the value of the company's proven oil and gas reserves as estimated by an independent engineering consultant using year-end prices discounted at 15%.

The company has unused cumulative Canadian oil and gas property expense of \$310,668, cumulative Canadian development expense of \$118,956, cumulative Canadian exploration expense of \$470,899 and earned depletion of \$54,610, available to reduce future taxable income.

4. BANK INDEBTEDNESS

The bank loan is payable on demand and bears interest at prime plus 1.5%. A floating charge debenture is pledged as collateral against the loan. The company also has a letter of credit outstanding in the amount of \$107,000. The letter of credit has subsequently expired.

5. CONVERTIBLE DEBENTURES

12% debentures: a floating charge subordinated to the bank is pledged as collateral for the debentures. Interest is payable quarterly. The debentures are convertible to common shares at a price of 66.67 cents per share. The debentures are repayable December 15, 1988 if not converted before then.

\$165,000

10% debentures: these amounts are unsecured. Interest is payable on maturity. The debentures are convertible to common shares at a price of 50 cents per share. The debentures are repayable May 20, 1989 if not converted before then.

100,000\$265,000**6. CONTINGENCY**

The company is a defendant in an action arising from the fiscal 1985 drilling of certain oil and gas properties which were placed on production during the year. The plaintiff's allege to hold an interest in the respective properties. The company is not able to estimate the effect, if any, on earnings which would result from settlement in the plaintiff's favor or on the resultant carrying value of the company's investment.

7. SHARE CAPITAL

	1987	1986
Authorized		
20,000,000 common shares without nominal or par value		
Issued 2,258,335 shares (1986 2,258,335)	\$1,388,029	\$1,388,029
To be issued 277,778 shares (1986 Nil)	100,000	—
	<u>\$1,488,029</u>	<u>\$1,388,029</u>

**SOUTHWARD ENERGY LTD.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Cont.)
FOR THE YEAR ENDED AUGUST 31, 1987**

On March 2, 1987 the issued share capital of the company was consolidated on the basis of one common share for each three then presently issued. The authorized capital remained unchanged. All references to share capital in these financial statements represent post consolidation amounts.

A subscription agreement was signed April 24, 1987 whereby the company offered 277,778 shares in exchange for \$100,000. A further 277,778 shares were reserved for warrants. The warrants have an exercise price of 40 cents and expire April 23, 1988. To date, neither the shares or warrants have been issued out of treasury.

On September 15, 1987 there were stock options issued in respect of 165,000 common shares exercisable at 45 cents per share. On September 18, 1987 there were further stock options issued in respect of 25,000 common shares exercisable at 45 cents per share. All of the options expire two years after issuance and were granted to directors and employees of the company.

8. NAME CHANGE

On March 2, 1987 the company changed its name from Southward Resources Ltd. to Southward Energy Ltd.

9. RELATED PARTY TRANSACTIONS

During the year, the company paid remuneration to, officers and/or directors or their nominees in the amount of \$90,167 (1986 - \$67,200). Included in accounts payable is an amount of \$18,682 (1986 - \$22,682) payable to the wife of a director. This amount bears interest at prime plus 1%, is without fixed terms of repayment and was originally advanced as a working capital loan. Also included in accounts payable are unpaid management fees of \$4,838.

10. SEGMENTED INFORMATION

The company conducts its petroleum and natural gas activities in Canada and the United States. Details of significant financial statement items are as follows:

	1987		
	Canada	United States	Consolidated
Net loss	\$ 83,342	\$ 4,698	\$ 88,040
Identifiable assets	\$1,194,114	\$ 33,025	\$1,227,139
Capital expenditures	\$ 202,276	\$ 10,394	\$ 212,670

	1986		
	Canada	United States	Consolidated
Net loss	\$ (966)	\$114,481	\$ 113,515
Identifiable assets	\$1,059,574	\$ 35,241	\$1,094,815
Capital expenditures	\$ 359,384	\$ 9,680	\$ 369,064

11. INCOME TAXES

As at August 31, 1987 the company had losses for income tax purposes in the amount of \$235,102 which are available to reduce future years' taxable income. The losses and their respective years of expiry are as follows:

1989	\$116,247
1990	23,984
1991	14,363
1992	80,508
	<u>\$235,102</u>

SOUTHWARD ENERGY LTD.
ANNUAL REPORT — CORPORATE INFORMATION

OFFICERS

Richard Wayne Kiser
President
Scott W. Kiser
Secretary Treasurer

DIRECTORS

Richard Wayne Kiser
Scott W. Kiser
Ronald W. Ambrose

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T2R 1K4

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Chartered Accountants
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TRADING SYMBOL

SWN

